

Testimony of
Independent Community Bankers of America
America's Community Bankers

on

H.R. 1474
Check Clearing for the 21st Century Act

before the

Subcommittee on Financial Institutions
and Consumer Credit

of the

Financial Services Committee

of the

United States House of Representatives

on

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and

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Mr. Chairman, Ranking member Sanders, and members of the Committee, my name is Rusty Cloutier. I am Chairman of the Independent Community Bankers of America ("ICBA"), and President of MidSouth National Bank, a \$394 million community bank located in Lafayette, Louisiana. I am pleased to appear today on behalf of the Independent Community Bankers of America, and America's Community Bankers, ("the banking trade associations") to share with you our views on H.R.1474, Check Clearing for the 21st Century Act, generally referred to as Check 21.

On behalf of the banking trade associations, I would like to extend our appreciation to Chairman Bachus for holding this hearing, as well as to Congresswoman Hart and Congressmen Ferguson and Ford for introducing this legislation. Our appreciation also extends to the Federal Reserve Board of Governors for bringing this issue to the attention of the House Financial Services Committee. Lastly, we appreciate the outstanding efforts of the staff of the House Financial Services Committee and the Federal Reserve Board ("Board") who worked tirelessly to address the concerns of the banking industry, consumer groups, and others in moving this legislation forward.

We strongly support the efforts to increase the efficiency of the nation's payments system, and we believe that through this proposed legislation, Congress can create significant cost savings and efficiencies that will benefit both consumers and financial institutions. Although we are not representing all of the banking and financial services trade associations today, we ask that the Committee duly note that the associations representing small and large banks and credit unions are united in support of this legislation. We believe that this united support is a testament to the needs that this bill addresses for the entire industry and its customers.

The Check Clearing Process Today

Today, most consumers have a variety of alternatives available to them to make non-cash retail payments. These include debit cards, credit cards, ACH debit, as well as traditional checks. According to the Board, American consumers make more than 70 billion non-cash retail payments each year. Board research also noted that the number of paper checks has been steadily declining since the mid 1990s, and that this decline is expected to continue. Yet, while the number of electronic payments continues to increase, traditional paper checks remain the non-cash payment of choice in the U.S. today.

Processing traditional paper checks in today's environment has become extremely costly and highly burdensome for the nation's financial institutions. Current law generally requires the original physical check to move through the entire clearing process from the bank of first deposit to the paying bank. This is a labor-intensive process involving handling, sorting and physically transporting checks. The logical solution to eliminating the cost and burden of processing physical checks is electronic processing. However, the primary impediment to a bank's adoption of electronic processing is the legal requirement that bank customers consent to not receiving their original check back after it is processed. Checks can currently be truncated at the paying bank because the paying bank can negotiate such an agreement with its customers. The bank of first deposit, however, does not have a relationship with the paying bank's customer. Therefore, it cannot obtain the requisite consent, and is thus prohibited from truncating the check at deposit to permit electronic processing, and must incur the costs of processing and transporting the paper check to the paying bank. There are rare exceptions, however, where banks have negotiated private agreements, namely very large banks with significant check volumes. This legislation would open the door for all financial institutions, and eliminate the requirement of the negotiated agreements, thereby facilitating the adoption and implementation of check truncation and electronic check processing.

Many banks have already streamlined their check clearing process. An increasing number of consumers do not have their original checks returned to them. Informal industry assessments estimate that more than thirty

percent of all checks drawn by bank customers, and nearly all checks drawn by credit union customers are not returned to the check writer. Depending on the financial institution's check safekeeping strategies, many consumers receive detailed information about their check transactions in their monthly account statement rather than receive their original checks. Some customers also receive images of canceled checks, and/or have the ability to access their check images online. Contrary to the concerns raised by the representatives of consumer groups, there is no evidence to support the argument that those consumers who do not receive their original checks back are disadvantaged in any way. The available detailed check transaction information and check images satisfies virtually all of the consumer's needs. Check images are routinely used and accepted, for example, as proof of payment, for tax records, etc., and the consumer rarely requests original items.

The removal, or truncation of paper checks from clearing, processing, and settlement activities is a growing trend for banks able to manage multiple unilateral relationships or agreements with other banks, and will continue regardless of whether this legislation is enacted. This environment, based on individual bank-to-bank agreements, would be far too onerous for my bank and the majority of the nation's smaller financial institutions. However, passage of this legislation will remove existing legal impediments, and facilitate the industry's progression towards more efficient check processing to the benefit of all participants without such agreements.

H.R. 1474 –The Proposed Check Clearing for the 21st Century Act

In response to the significant costs and inefficiencies associated with check processing, the Board's Payments System Development Committee sought input from the banking industry, consumer groups, check clearinghouses, processors, and others in developing a proposed legal framework to remove the barriers to the wide scale use of truncation and electronic processing. The Fed's efforts served as the foundation for H.R. 1474, Check Clearing for the 21st Century Act.

The proposed legislation facilitates check truncation, and authorizes the use of "substitute checks," a paper reproduction of the original check that is suitable for automated processing in the same manner as the original check. The legislation mandates that the substitute check: (1) accurately represents all information on the front and back of the original check including all required MICR line information, and all prior endorsements (whether in electronic or paper form); (2) conform to industry standards; and (3) contain a legend stating "This is a legal copy of your check. You can use it the same way you would use the original check." In addition, the substitute check must identify the bank creating the substitute check, known as the reconverting bank.

The legislation creates a warranty structure to protect against the risk of loss that may be associated with the use of substitute checks. The warranties are intended to protect against situations in which a substitute check does not meet the standards for legal equivalence, or in which a party receives a duplicate request for payment after the substitute check has been paid. The reconverting bank and each subsequent bank that handles the substitute checks grants these warranties.

There is also an indemnity structure that is designed to address losses that may result solely because a substitute is presented rather than the original. These losses could occur due to a breach of warranty or other circumstances such as forgery. Like the warranty, the indemnity, is given by the bank creating a substitute check and by each subsequent bank that handles the item. The provision is specifically intended to put parties in the same position as if the original check had been processed.

Moreover, in instances where additional follow-up is needed to resolve claims, the legislation appropriately requires the indemnifying bank to provide the original check or a copy. We applaud granting the indemnifying bank the flexibility to either provide the original check or a copy of the original sufficient to resolve the claim.

The legislation will open the door for the banking industry to use electronic images to process and clear checks, but does not mandate the processing or receipt of checks in electronic form. Physical transportation, handling and sorting would phase out over time as financial institutions of all sizes and types recognize the benefits of not moving the paper. No longer would my bank have to transport a check drawn on a New York bank halfway across the country for clearing, processing and settlement. Checks could be processed and transmitted electronically in lieu of the original paper check. More importantly, the proposed legislation does not require the banking industry to adopt a fully electronic check clearing system; rather it provides the flexibility, on a bank-by-bank basis, to adapt to electronic check clearing over time without interfering with the existing paper check process.

We strongly support a proposed effective date of eighteen months from Check 21 enactment. This period should provide sufficient time for the banking industry to adopt standards, procedures, and products to comply with Check 21 requirements. We do, however, have concerns that the existing definition of "substitute check" requiring banks to include all the MICR line information on the original check would create a number of technological challenges dramatically slowing down implementation of the processing models envisioned under the legislation. Our concerns would be addressed by an alternative requirement that a substitute check contain MICR line information as prescribed by generally applicable industry standards, which require all of the MICR line information important to check processing.

Check Truncation and Imaging

The banking trade associations believe that removing the legal impediments to the expanded use of electronics for check clearing and settlement will, over time, improve the efficiency of our nation's payments system, and provide benefits to consumers as well as banks. Expanding the use of electronics in check processing will help streamline the collection and return of checks, reduce processing costs, and minimize the effect of unexpected disruptions to air and ground transportation systems.

This legislation will also promote imaging technology that can help speed processing and improve service to customers. Many consumers are already enjoying the benefits and conveniences associated with check imaging. Rather than dealing with bundles of canceled checks, consumers receive concise and convenient summaries of their transactions, which simplify account reconciliation. Moreover, reducing the dependency on the physical presentment of original items will, over the long term, result in expedited check collection, expedited funds availability and statement delivery, better quality statements and less fraud. These benefits go beyond simple consumer conveniences. The ability to access check images on the Internet helps consumers to quickly and conveniently verify their transactions, identify potential errors, and detect fraudulent transactions sooner by reviewing their check images online. Identifying errors and potential fraud as soon as possible helps banks minimize customer inconvenience, control potential losses, and gives law enforcement an advantage in tracking down perpetrators. Current check imaging applications will expand with the additional application of check truncation.

Finally, it is important to note that this legislation will provide real benefits to community banks and their customers. Critics of this legislation have expressed concern over relying too heavily on check images. The experiences of my institution and of many others who have been offering imaged check statements for a number of years demonstrate that these concerns are unfounded. MidSouth Bank implemented check imaging in June 1999 because we felt that check imaging would streamline the delivery of products and services to our customers, keep us competitive and generate a return on our investment. The cost of the software was approximately \$105,000 and the hardware was approximately \$373,000. The benefits have been enormous. For the customer, we are able to expedite statement delivery along with improving the quality of the statements. Account reconciliation has been simplified, and we can respond to inquiries in minutes instead of hours. For the bank, imaging has led to significant cost reduction, particularly in postage expenses. We have

experienced improved productivity in the item processing area, simplified statement preparation, and improved statement storage.

Our customer response was overwhelmingly positive. We did not give any of our customers the choice of opting out of receiving imaged checks in lieu of their original checks. The first month of implementation, we sent 17, 941 statements and received 48 customer calls, representing a quarter of one percent of our checking account customer base. The number one complaint was with the size of the images. Initially, we printed 18 images per page, but subsequently changed this to 12 images per page. As of last week, neither my bank, nor my accountholders (4,956 commercial, and 17,474 personal) have incurred a loss due to the bank's implementation of check imaging.

We occasionally receive customer requests for copies of checks in instances where proof of payment is needed or where they have misplaced their bank statements. Frequently, requests are fulfilled while the customer is still in the bank. Most requests are fulfilled within the same banking day. We also keep our image disks under lock and key consistent with our commitment to protecting the privacy and confidentiality of our customers' information.

Moreover, a survey of the ICBA's membership reveals community bank use and interest in image check processing. According to the ICBA/InFinet Resources *2002 Community Bank Technology Survey*, 47% of the respondents have deployed image check processing, and another 41% are planning to evaluate the technology within the next twelve to eighteen months. Anecdotal information from the industry regarding consumer acceptance and monetary losses is comparable to the experiences of my bank.

Post Check 21 World

My staff and I are very excited about a post Check 21 world where end-to-end electronic check processing, clearing, and settlement is commonplace. At this time, we have not identified the cost of implementing such a processing environment, but we are confident that the benefits, over the long term, will far outweigh implementation costs. We will soon begin work to determine the best processing environment for our bank. We do know that the Federal Reserve and numerous private-sector providers will have competitive product offerings that support a post Check 21 world. For the banks that cannot afford to move to an end-to-end imaging system, we are confident that competitive marketplace solutions from the Federal Reserve and the private sector will be available to support a staggered image environment or substitute check processing.

Existing Consumer Protections for Checks are Adequate

The banking trade associations believe that existing law provides adequate protection to consumers for the substitute checks authorized under the proposed legislation. Banks and consumers have an established history of dealing with truncated checks and image documents. There have been no significant consumer issues relating to the receipt of images or electronic representations of return check items, and there is no evidence to justify changing the existing law to provide for additional consumer protections. Further, Board staff has indicated that a review of the consumer complaints filed with all of the banking regulatory agencies reveals no significant consumer issues relating to the timely resolution of check complaints, including instances where the checks are not returned to the accountholder.

Under the Uniform Commercial Code, a bank is liable to its customer if it charges its customer's account for a check that is not "properly payable." This includes checks that are not authorized by the consumer, checks containing a fraudulent endorsement or signature, and other erroneously posted checks. A bank that improperly debits a customer's account is liable to the customer not only for the amount of the improper debit, but also for the amount of any damages that are caused by any checks that are returned due to insufficient

funds resulting from the improper debit. Additional protections and funds availability schedules are provided under the Board's Regulation CC, which implements the Expedited Fund Availability Act. For example, under Regulation CC returning banks warrant to the bank customer to whom the check is being returned that they have returned the check in accordance with the requirements of applicable law, that they are authorized to return the check, and that the check has not been materially altered. These laws ensure check-related disputes are handled appropriately, and they apply whether the original check, an image, or a statement notation is involved.

Proposed Expedited Re-credit Provisions Are Unnecessary and Will Promote Fraud

We believe that the complicated new re-credit procedures would only serve to confuse customers, create unnecessary burden for banks, without commensurate consumer benefit, and expose banks to potential new sophisticated fraud schemes. Most importantly, the Board has now concluded that the expedited recredit provisions it originally suggested are not necessary, according to testimony given by Federal Reserve Board Vice Chairman Roger W. Ferguson, Jr. before the Senate Committee on Banking, Housing, and Urban Affairs, on April 3, 2003.

The proposed legislation establishes a complicated expedited re-credit and reversal of re-credit structure for consumers and banks that will promote fraud. Section 6 provides that consumers may make claims for expedited re-crediting if they assert that the bank charged the account for a substitute check that was not properly charged and that production of the original check or better copy of the original check is necessary to determine the validity of the charge. The bank then must either produce the original check or better copy and show that the account was properly charged or re-credit the consumer account for the amount of the check up to \$2,500 within 10 business days. The remainder must be re-credited within 45 calendar days following the business day of the claim. Funds must be available the business day after re-crediting. However, banks may delay availability under certain circumstances -- the account is "new;" the account has been repeatedly overdrawn or the bank has reasonable cause to believe that the claim is fraudulent. Accordingly, we strongly recommend eliminating the expedited re-credit provisions, retaining current check law, and relying on the new warranty and indemnity provisions in the proposed legislation.

Consumer groups are demanding that the expedited re-crediting provisions extend to all truncated checks, including those provided today with the customer's consent. Existing check law has a long, proven record of success in the truncated environment. If a single consistent rule is adopted, it should be based on current law, rather than new law that will arguably promote fraud and impose new burdens on banks without commensurate customer benefits.

Representatives of consumer groups also argue that consumers need protections above and beyond what is required today because they will be at a disadvantage if they receive substitute checks rather than originals. However, the situations they cite in support of this argument have existed for years in the truncated environment, supported by older technologies, without adverse consequence to consumers. As noted earlier, millions of bank customers receive check images with their statements. Generally, banks that have adopted check imaging destroy the original checks within 30 to 90 days. My bank destroys all original checks after 90 days. In many cases, by the time the consumer requests the check, it has already been destroyed, and only a copy is available. Thus, the environment under the proposed legislation will differ very little from the environment of today.

Conclusion

The banking trade associations strongly support Check 21's general principle of facilitating check truncation and fostering innovation in the payments system without mandating electronic processing of checks. Removing

the legal impediments to the expanded use of electronics for check clearing and settlement will improve the efficiency of our nation's payment system to the benefit of both banks and consumers. We also believe that the body of law and regulations that has developed around the existing check clearing processes is both effective at protecting consumers and minimizing the banking industry's exposure to fraud. The demands by consumer groups for additional consumer protections are unfounded. The banking industry and consumer experience with existing check safekeeping and truncations processes demonstrate that existing law and regulations work.

We urge members of the committee to consider changes to the proposed legislation that will preserve existing law with respect to substitute checks. In addition, we urge modifying the "substitute check" definition so that the marketplace can flexibly respond to changing technologies and processing models through the modification of generally applicable industry standards rather than seeking statutory revisions. We hope members will also take this opportunity to improve the efficiency of the U.S. payments system by quick passage of the proposed legislation, which has the broad support of the banking industry and the Federal Reserve Board.

Represented Organizations

Independent Community Bankers of America

ICBA is the nation's leading voice for community banks and the only national trade association dedicated exclusively to protecting the interests of the community banking industry. We aggregate the power of our members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

ICBA has 5,000 members with branches in 17,000 locations nationwide. Our members hold nearly \$511 billion in insured deposits, \$624 billion in assets and more than \$391 billion in loans for consumers, small businesses, and farms in the communities they serve. ICBA members employ more than 231,000 people.

America's Community Bankers:

America's Community Bankers represents the nation's community banks of all charter types and sizes. ACB members, whose aggregate assets exceed \$1 trillion, pursue progressive, entrepreneurial and service-oriented strategies in providing financial services to benefit their customers and communities.